

STATEMENT OF
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before the
Legislation and National Security Subcommittee
of the
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Mr. Chairman and Members of the Committee:

I am pleased to appear before you to discuss the outlook for inflation as projected by the Congressional Budget Office and other economists, and in particular, the implications for defense spending. My testimony today will focus on three areas:

- o The general outlook for inflation through 1986;
- o The specific outlook for inflation with regard to defense purchases; and
- o The potential impact for defense spending.

The General Outlook for Inflation

Private forecasters, such as Chase, Data Resources, Inc. (DRI) and, Wharton (WEFA), see inflation coming down slowly over the next five to six years. They generally agree that inflation during 1981 will be about 10 percent (on a year over year basis), and that the rate of inflation should decline over the next several years. CBO concurs with this view. Forecasts differ, though, about how quickly inflation will decline after 1981. For example, the projections for inflation in 1984 range from 6.0 percent to 8.4 percent. By 1986, the disparity is even wider--4.9 percent to 8.6 percent.

Table 1 provides a series of projections for inflation for the 1981-1986 period. In this table, the inflation index used is the Gross National Product (GNP) Deflator, which is considered the best index available for measuring general inflation trends.

TABLE 1. COMPARISON OF INFLATION PROJECTIONS, 1981-1986
(GNP Deflator, percent change, calendar year over calendar year)

	1981	1982	1983	1984	1985	1986
Private Forecasts <u>a/</u>						
DRI	10.4	9.6	9.0	8.1	8.7	8.5
Chase	10.2	9.1	7.6	7.6	7.4	--
Evans	10.0	8.8	8.4	8.4	7.5	6.6
Merrill Lynch	9.5	7.1	5.9	6.1	--	--
WEFA Annual	10.3	9.5	8.1	7.6	8.0	8.6
Administration Projections						
January budget	10.5	9.3	8.5	7.8	7.0	6.3
March revisions	9.9	8.3	7.0	6.0	5.4	4.9
Congressional Budget Office						
Baseline projections <u>b/</u>	10.3	9.2	8.6	8.1	7.6	7.1
Alternative projections <u>c/</u>	10.3	9.2	8.6	8.1	7.5	7.0

a/ These data represent model vendors' forecasts of the effects of the Reagan Administration plan in its February 18, 1981 form.

b/ Based on a continuation of current policy, including the tax cuts assumed for the 1981 budget resolution.

c/ Based on the Administration's budget proposals.

The Administration's projection for inflation is more optimistic than any private forecasters'. Its March budget assumptions are consistently at the lower end of the range. As a result of its policy proposals, the Administration expects the general annual rate of inflation to decline steadily, from the current 10 percent-plus rate to less than 5 percent by 1986. The key Administration policies designed to achieve this result are a gradual slowing of the growth of money and credit along a preannounced and predictable path, and increased economic growth accomplished by various tax cuts and regulatory changes.

CBO's projections of inflation are more in line with those of the private forecasters, and they are more pessimistic than the Administration's. Under the CBO projections, inflation averages about 1.5 percent a year higher. CBO assumes that inflation will respond more slowly to monetary policy, as past experience suggests.

CBO's view on prices is based on the post-World War II experience that, once inflation starts, it builds up great momentum that can persist even through a recession. This momentum is sustained in part by the ability of many wage earners to catch up with rapid inflation that has already occurred, whatever its cause and whatever the state of the labor market. Since labor costs account for roughly three-quarters of total business costs, wage increases that outrun productivity push prices upward.

In the face of poor luck on food and energy prices, restrictive monetary and fiscal policies have been able to slow the momentum of inflation only gradually--and with a significant concurrent loss of production and employment. Last year, for example, relatively tight money, record high interest rates, and credit controls helped induce the seventh postwar recession. But there was little immediate beneficial impact on inflation since wage increases accelerated. The average hourly earnings index rose by 10 percent from January 1980 to January 1981, up from the 7.7 percent gain of a year earlier, even though the number of unemployed increased by 1.5 million. And the continued rapid rise in consumer prices last year suggests another sharp catch-up increase in wages in 1981.

Any economic forecast or projection is of course subject to a wide margin of error. The outlook today is made especially uncertain by two factors: the magnitude of the fiscal policy changes proposed by the Administration, and the possibility that--in a period of "stagflation"--past experience may be a misleading guide to future developments.

If the Administration's economic policies are adopted, the outlook could be more optimistic than CBO projects for a number of reasons. First, the budget changes--especially the personal tax cuts--could have a greater impact on total productive capacity than past experience suggests. Second, tight monetary policy--by operating directly on price expectations--could induce a quick slowdown in inflation with little loss of production or jobs. Third, the promised regulatory changes could lower inflation and encourage more investment and growth.

On the other hand, the next five years could be worse than historical experience suggests. In particular, world commodity prices--especially for oil and food--may rise even more sharply than projected as a result of poor weather, instability in the Middle East, or some other uncontrollable factors. The CBO projections assume that there will be no such price shocks through 1986--an assumption that persistently caused projections made in the 1970s to underestimate future inflation.

Inflation Outlook for Defense Purchases

The prices paid by the Defense Department to procure major weapons systems and military supplies have typically increased faster than prices in general. Over the past five fiscal years, defense purchase prices have risen at a faster pace than the general inflation rate--by an annual average of more than 1.5 percentage points (see Table 2).

TABLE 2. COMPARISON OF GNP AND DEFENSE PURCHASE DEFLATORS (Percent change, fiscal year over fiscal year)

	1976	1977	1978	1979	1980
GNP Deflator	7.0	6.8	6.8	8.7	9.3
Defense Purchases	7.9	7.3	7.7	9.0	14.9

Based on the historical relationship between the general inflation rate and increase in prices for defense purchases, CBO has developed a specific set of inflation projections for defense purchases for the 1981-1986 period. These projections are shown in Table 3, together with the price assumptions the Administration has used for defense budget estimates. The CBO inflation projections for all defense purchases average 2 percentage points per year higher than the Administration's assumptions. For fuel costs, the CBO projections are much higher than the Administration's--an average of about 7 percent higher per year. For procurement, the average difference is about 2.5 percentage points per year.

TABLE 3. COMPARISON OF INFLATION INCREASES OF SELECTED COMPONENTS OF THE DEFENSE DEPARTMENT BUDGET UNDER CBO AND ADMINISTRATION JANUARY AND MARCH ECONOMIC ASSUMPTIONS (By fiscal year, in percentage change)

Component	1981	1982	1983	1984	1985	1986
Fuel						
CBO <u>a/</u>	30.1	20.1	14.5	12.3	12.1	12.1
January budget	23.3	9.7	8.6	8.0	7.2	6.4
March revisions	26.6	8.7	7.3	6.2	5.5	5.0
Procurement						
CBO <u>a/</u>	9.2	8.9	8.5	8.3	8.1	8.1
January budget	8.6	8.0	7.5	7.5	6.5	6.4
March revisions	7.4	6.5	5.8	5.4	5.1	5.0
Total Defense						
CBO <u>a/</u>	12.7	10.8	8.9	8.4	8.0	7.6
January budget <u>b/</u>	--	--	--	--	--	--
March	11.4	8.9	6.9	6.2	5.6	5.3

a/ Based on CBO assumptions for all purchases except military and civilian pay, for which the Administration's pay raise proposals are used.

b/ The January total defense deflator does not provide a valid basis for comparison, because it assumes a different set of pay raise assumptions.

Potential Impact On The Budget

Assumptions about future inflation are particularly important for the defense budget. This is because the budgetary practice is to provide full funding for the procurement of major weapons systems in the initial year of appropriation. In effect, the budget provides for anticipated future inflation

"up front", rather than on a year-to-year basis. If the initial assumptions about future inflation turn out to be too low--as has been the general rule lately--then either the Defense Department has to ask for more funds, or it has to buy less, or it has to reallocate funds from other uses.

For the 1982-1986 period, the potential budgetary impact of higher inflation than the Administration assumes for defense spending is considerable. For example, CBO estimates that for fiscal year 1982, an additional \$6.7 billion in budget authority would be required to fulfill the Administration's projected defense spending plans. This additional budget authority includes \$1.6 billion for projected fuel consumption, \$2.7 billion for full funding of proposed weapons purchases, and \$2.4 billion for supplies and other purchases.

For the longer term, if the inflation rate follows CBO's path, defense appropriations by 1986 could be about \$50 billion higher than projected by the Administration in its March budget revisions (see Table 4). This assumes that the Administration holds to its goal of increasing the real growth in defense spending by an average of about 7 percent per year after 1982. Secretary Weinberger has testified that the Administration would request additional defense funds if inflation turns out to be higher than the Administration has assumed.

TABLE 4. CBO REESTIMATES OF ADMINISTRATION'S DEFENSE BUDGET BASED ON ALTERNATIVE ECONOMIC ASSUMPTIONS (Budget authority by fiscal year, in billions of dollars)

	1981	1982	1983	1984	1985	1986
Administration Estimate	180.7	226.3	259.6	294.9	333.0	374.3
CBO Adjustment for Purchase Prices	<u>2.1</u>	<u>6.7</u>	<u>13.9</u>	<u>22.7</u>	<u>34.1</u>	<u>48.7</u>
Subtotal	182.8	233.0	273.5	317.6	367.1	423.0
CBO Adjustment for Pay Raise	<u>-0.4</u>	<u>-0.3</u>	<u>0.7</u>	<u>1.7</u>	<u>2.6</u>	<u>3.5</u>
Total	182.4	232.7	274.2	319.3	369.7	426.5

Conclusion

The U.S. economy has performed very poorly in the last few years, frustrating serious attempts by the Congress to reduce the growth of federal spending and to move away from chronic budget deficits. In 1980 the continuation of near record inflation, high unemployment, lagging productivity, and unprecedentially high interest rates battered the economy. Last spring, we experienced a sharp, though brief, decline in output. It increased unemployment and the amount of unused capacity; but it did little, if anything, to ease inflation. Moreover, the upturn in economic activity in the second half of the year drove interest rates to new record highs, raising doubts about whether the recovery would be last.

In response to this situation, President Reagan has proposed a dramatic shift in economic policies designed to stem inflation, stimulate economic growth, and balance the budget by 1984. There are legitimate

differences among economists as to whether the Administration's budgetary and other policies are likely to produce the favorable results assumed in the Administration's economic scenario. No one can be certain. Past projections of the economy and of the budget have not been very accurate. Recent experience does suggest, however, that the prudent course would be to prepare for worse economic performance and larger deficits than the Administration assumes. In particular, if inflation does not unwind as quickly as the Administration anticipates, defense spending could rise considerably faster than the Administration has projected, or the Administration may have to scale back its plans for defense purchases.